TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Request for Board Action on Pension Obligation Bonds for Contributions to CalSTRS

ITEM NUMBER: 12

ATTACHMENT(S): 2

ACTION: X

MEETING DATE: March 6, 2003

INFORMATION: ___

PRESENTER: Ed Derman

Under current law, there is an annual appropriation of money from the General Fund to the Teachers' Retirement Fund to pay a portion of the cost of benefits provided under the Defined Benefit (DB) Program. In 2003-04, that appropriation will equal 2.017 percent of the compensation upon which member contributions in 2001-02 were based, and will equal $448 million. That amount will be paid in four equal quarterly payments, beginning July 1, 2003. This contribution is fixed in statute, and is not affected by the existence of an unfunded actuarial liability (UAL) or surplus in the program.

The Governor's budget indicates that two alternative means of financing that contribution are being considered by the Department of Finance. The first approach is for California State Teachers' Retirement System (CalSTRS) to enter into a fixed income investment with the state. The proceeds of that investment would be available to pay expenses of the state, such as the General Fund contribution to the DB Program. The second alternative is for the state to issue what is referred to as a pension obligation bond, and use the proceeds to pay the 2003-04 contribution to the DB Program. This second alternative is the subject matter of this item.

PENSION OBLIGATION BONDS

Pension obligation bonds are issued by sponsors of public retirement systems in order to reduce the long-term cost of financing pension liabilities. Public pensions often have an UAL, which reflects the value of benefits owed to plan participants for service already performed that is in excess the value of the actuarial value of plan assets. This UAL is generally paid over time by increasing regular contributions to the plan. The cost of financing the amortization of the UAL will be affected by the actuarially assumed rate of investment return for plan assets. In the case of the DB Program, for example, that rate is currently 8 percent. An alternative means of financing the amortization of the UAL is to infuse a sum of money equal to the UAL. This infusion of funds could be derived from the sale of bonds, known as pension obligation bonds. If the rate of interest paid on these bonds is less than the actuarially assumed rate of return, the cost of amortizing the UAL will be less to the plan sponsor.

The Department of Finance, however, is considering a different use of pension obligation bonds in 2003-04. Rather than using the bond proceeds to reduce or eliminate the UAL in the DB Program, which would not affect the General Fund contribution to the DB Program, the Department of Finance is considering the issuance of bonds to pay the 2003-04 General Fund contribution to the DB Program. (The Governor's budget proposes a different approach to address the $555 million General Fund contribution to the Supplemental Benefit Maintenance Account for the purchasing power program, which the Teachers' Retirement Board (Board) began addressing at the January meeting. Staff has no reason to believe, however, that the General Fund contribution to that program couldn't also be financed through the sale of bonds.) The department is considering a similar use of bond proceeds to pay the General Fund contribution to the California Public Employees' Retirement System (CalPERS). The anticipated bond issue would total $1.5 billion for both retirement systems. The bonds would be amortized over a 20 year period, and paid from the General Fund.

To issue the bonds quickly enough to make a July 1, 2003 payment will require an unfettered series of steps. First, legislation to authorize the issuance of bonds will have to be enacted by the Legislature by the end of February. Second, a court proceeding to validate the issuance of bonds for such purposes will have to be successful and without any protest. Third, there will have to be an adequate market for the purchase of such bonds by investors. If any of these steps does not occur on time, than the issuance of the bonds could be delayed. If this effort falters, the General Fund contributions to the DB Program would occur as currently required by law.

BOARD INVOLVEMENT IN BOND ISSUANCE

If the bond issue occurs as hoped by the Department of Finance, the DB Program will receive contributions as required by law, but from a different source, the proceeds of a bond that is redeemed by the General Fund, rather than from the General Fund directly. Nonetheless, the Board has a role to play in the issuance of the bonds, and potentially an issue to address before the bonds is issued.

According to the Attorney General, subject to statutory authorization, the state can issue pension obligation bonds to pay a statutory obligation imposed on the state. In this case, that obligation is the requirement in statute that the General Fund pay contributions to CalSTRS for the DB Program. To meet the Attorney General's requirements, the Board must adopt a resolution that specifies the minimum amount owed by the state to CalSTRS. In addition, prior to the bond sale, a debenture will be executed between CalSTRS and the bond trustees that outline the amount owed by the General Fund, and other related matters. The Board must authorize either the Board chair or the Chief Executive Officer (CEO), to sign the debenture on behalf of the Board. A draft of the debenture is attached.

One of the provisions of the debenture is the recognition that the quarterly contributions can be pre-paid. Once the bond is sold and the proceeds received, they will immediately be distributed to CalSTRS and CalPERS to satisfy the legal obligation to pay contributions. If that sale takes place before July 1, 2003, the entire 2003-04 contribution to the DB Program will be paid at the beginning of the year, rather than in four installments. As a result, the DB Program will have more assets available to invest at the beginning of the year. At this time, the Department of Finance is not seeking any fiscal relief for pre-paying the contributions, but that issue could be brought to the Board between now and July. In addition, the legislation authorizing the issuance of bonds will have to permit the prepayment of contributions.

STAFF RECOMMENDATION

As currently proposed, the issuance of pension obligation bonds could provide a means for the state to address its budget shortfalls, without adversely affecting the financing of CalSTRS benefit programs. To facilitate the issuance of pension obligation bonds by the state, staff recommends:

1. The Board adopt the attached resolution specifying the statutory obligation of the state to make a contribution to CalSTRS benefit programs.
2. The resolution identify that obligation to be $448 million, paid in equal quarterly payment, beginning July 1, 2003, for the Defined Benefit Program, and $555 million, to be paid July 1, 2003, to the Supplemental Benefit Maintenance Account (SBMA). Although the issuance of bonds to fund the SBMA contribution is not currently being considered by the Department of Finance, including that obligation in the resolution maintains flexibility for such a change to occur prior to the issuance of the bonds.
3. The Board recognize that, if legislation is enacted to permit pre-payment of contributions, that the statutory contributions could be pre-paid, subject to terms and conditions approved by the Board.
4. The Board authorize the CEO to sign the debenture document on behalf of the Board prior to the sale of bonds. Authorizing the CEO, rather than the Board chair, to sign the debenture document would permit a more expeditious execution of the document.

No. [1][2] $_____________

STATE OF CALIFORNIA

Pension Obligation Debenture

The Teachers' Retirement Board ("Board"), exercising the plenary authority and fiduciary responsibility vested in it pursuant to Article XVI, Section 17 of the Constitution of the State of California (the "State"), in order to protect the actuarial soundness of the State Teachers' Retirement Plan hereby determines that the annual contribution payments to the California State Teachers' Retirement System ("CalSTRS") from the State payable in Fiscal Year 2003-2004, hereby determines that the annual contribution payments to CalSTRS from the State payable in Fiscal Year 2003-2004, will amount to at least ______________ ($_____________), payable by the State in accordance with the following schedule:

(Payment Date)	Principal Amount
July 1, 2003	$
October 1, 2003	
January 2, 2004	
April 1, 2004	

The State hereby acknowledges that the annual contribution payments to CalSTRS from the State payable in Fiscal year 2003-04, are as set forth above, and that the obligations of the State to make such payments when due are obligations of the State imposed by law and are absolute and unconditional, without any right of set-off or counterclaim.

This Debenture, issued by the State in evidence of those obligations, is a duly authorized debenture of the State designated its "Pension Obligation Debenture" (the "Debenture") in the aggregate principal amount of $_____________ issued under and in full compliance with the Constitution and statutes of the State of California, particularly Article XVI, Section 17 of the Constitution and the California Pension Obligation Financing Law and under and pursuant to Resolution No. ____ adopted by the Pension Obligation Bond Committee of the State on _____________, 2003 (the "Resolution").

This Debenture may, at any time and from time to time, be prepaid by the State in whole or in part, subject to enactment of legislation authorizing such prepayment and subject to terms and conditions acceptable to the Board.

This Debenture does not constitute an obligation of the State for which the State is obligated to levy or permitted to pledge any form of taxation or for which the State has levied or pledged any form of taxation.

It is hereby certified and recited that all conditions, acts and things required by law to exist, to have happened and to have been performed as a condition to the issuance of this Debenture by the State do exist, have happened and have been performed in due time, form and manner as required by law.

IN WITNESS WHEREOF, THE STATE OF CALIFORNIA has caused this Debenture to be signed in its name and on its behalf by the manual or facsimile signature of the Chairperson of the Pension Obligation Bond Committee of the State and its seal (or a facsimile thereof) to be hereunto affixed, imprinted, engraved or otherwise reproduced, as of the ___ day of _____________, 2003.

STATE OF CALIFORNIA

BY PENSION OBLIGATION BOND COMMITTEE

By ____

[SEAL]

Attest:

____

ACCEPTED AND AGREED TO BY:

STATE TEACHERS' RETIREMENT SYSTEM

By __________________________________

PROPOSED
RESOLUTION OF THE
TEACHER'S RETIREMENT BOARD

SUBJECT: Authorizing Acceptance of
Pension Obligation Bond Debenture

WHEREAS, in accordance with Parts 13 and 14 of Division 1 of Title 1 of the Education Code (the "Teachers' Retirement Law"), the Teachers' Retirement Board is charged with the administration, management and control of the California State Teachers' Retirement System ("CalSTRS"), and

WHEREAS, in accordance with Article XVI, Section 17 of the California Constitution (the "Constitution"), the Teachers' Retirement Board is charged with plenary authority and fiduciary responsibility for administration of CalSTRS, and

WHEREAS, the State of California (the "State") has the duty, pursuant to the Constitution and the Teachers' Retirement Law, to make contributions to CalSTRS and

WHEREAS, the Teachers' Retirement Board has determined that the contributions to CalSTRS by the State in fiscal year 2003-04 will amount to at least $1.003 billion, consisting of at least $448 million, to be paid in equal quarterly amounts beginning on July 1, 2003 pursuant to Section 22955 of the Education Code, and at least $555 million, to be paid in one payment on July 1, 2003 pursuant to Section 22954 of the Education Code, and

WHEREAS, on _____________, 2003, the State authorized the issuance of a Pension Obligation Debenture (the "2003 Debenture") to evidence its obligation to the System in Fiscal Year 2003-04, and

WHEREAS, there has been presented to this meeting a form of 2003 Debenture, therefore, be it

RESOLVED that the Teachers' Retirement Board hereby approves the 2003 Debenture, substantially in the form presented to the Teachers' Retirement Board at this meeting, in an initial principal amount of not to exceed 1.003 billion. The Chief Executive Officer of CalSTRS is hereby authorized to execute and accept a 2003 Debenture on behalf of the System, in substantially such form, with such changes therein, deletions therefrom and additions thereto as the Chair shall approve, which approval shall be conclusively evidenced by the execution and acceptance thereof.

RESOLVED further that the Teachers' Retirement Board acknowledges that, subject to the enactment of legislation authorizing the prepayment of contributions to CalSTRS, the debenture may be prepaid by the State in whole or in part, subject to terms and conditions acceptable to the Teachers' Retirement Board, and

RESOLVED further that the Chief Executive Officer is hereby authorized and directed to execute and deliver any and all documents, certificates and instruments, and to take any and all actions, necessary or appropriate to consummate the transactions contemplated by this Resolution and otherwise to carry out, give effect to and comply with the terms and intent of this Resolution.

Adopted by:
Teachers' Retirement Board

On March 6, 2003

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JACK EHNES
Chief Executive Officer